Macro Talking Points

Fixed Income Insights

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In brief

- **Q&A summary from our Miami client roadshow**
- **US IG credit spreads look tight, but there is no cause for panic**

Goldilocks and the three gators: Q's. I spent last week in Miami meeting with investors. Here is a selection of the top issues discussed. On the macro side, key questions revolved around the growth scenarios and the persistence of inflation. One question related to the most vulnerable sectors of the US economy. Monetary policy was also a major topic, including the outlook of the US Federal Reserve. Moving on to fiscal policy, US fiscal risks came up as a major source of concern. On fixed income markets, investors questioned the spread valuation backdrop, and many wondered why it would make sense to do anything other than buy short-tenor US Treasuries or stay in cash. On a related note, investors asked whether it was appropriate to establish a long duration position and whether there was a preferred segment on the curve in terms of positioning. Away from fixed income, we received questions about the outlook for the US dollar. Finally, global risks were heavily discussed, including elections and geopolitics.

Goldilocks and the three gators: A's. With respect to the growth outlook, a soft landing seems to be the prevailing scenario at this juncture, especially after the recent softer data (for instance, initial claims and ISM services). This means that the no-landing scenario appears less likely and the threat of recession remains fairly remote. Growth continues to be mainly driven by the strength of both the consumer and the corporate sectors, but there are more fragile segments of the economy, including commercial real estate and smaller financials. On the inflation front, the recent pace of disinflation has weakened to a slow grind, but if housing inflation starts to normalize, along with some parts of core services inflation, we see a path for core to moderate, albeit at a gradual pace. On the Fed outlook, uncertainty over the timing and magnitude of rate cuts has risen, but rate cuts remain on the table, in our view. Whether the Fed kicks off its easing cycle in July or September is still unclear, while the case for an earlier start in June is now considerably weaker. On the fiscal side, the outlook in the United States is problematic, but it has shown signs of moderation over the past couple of months (*i.e.*, the fiscal deficit is now marginally lower). In addition, we don't anticipate the fiscal challenges to be tackled forcefully until well after the election. As a result, we view the US fiscal outlook as a medium-term risk, with little hope of resolution in the near term. On fixed income, we are not overly concerned about spread valuation, even though the backdrop is challenging (more on that below). We are constructive on credit risk given the macro backdrop, and we believe that break-even yields remain attractive despite spread levels. As a result, exposure to credit makes sense in our view, given the benefits of higher yields. On the duration view, for the investor with a long time horizon, establishing a longer duration position seems appropriate to us given where we are in the rate cycle. We also emphasized that the US credit curve is positive sloping, in contrast to the US treasuries curve, which is still inverted. With that in mind, positioning in the belly of the credit curve appears attractive, in our view. With respect to outlook for the dollar, uncertainty has risen, especially in view of the reduced visibility on the Fed front. The USD does appear to be tactically overvalued, but the macro signals for a downward correction are a bit weaker than a few months ago. Finally, we agreed with the Miami investors that the US election risk is a major consideration, especially given the significant uncertainty surrounding the future policy agenda. As such, we believe that the best way to protect against rising political risks remains to pursue a diversified approach to investing through exposures to different asset classes and geographies.

Should we be concerned about IG Corp spread valuation? Investment grade spreads are rich by historical standards. Our fixed income valuation score places US IG spreads in overstretched territory. But there are a few reasons why this may not trigger an imminent sell signal. For a start, market technicals appear to be strong, with demand for credit being particularly robust. From a fundamental standpoint, we fail to see a catalyst that could trigger a spread correction. Finally, periods of stretched spreads are fairly common. A look at historical data show that credit spreads can stay rich for an extended period of time. On a separate note, we would point out that for the long-term investor with a total return focus, what we believe matters most is the total yield valuation backdrop, which still looks attractive to us.